

Alpha shares analysis

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Two companies well positioned to deliver solid growth

This week we look at two companies with good opportunities in their end markets and solid quality characteristics. One owns a brand UK consumers will be familiar with, the other is a US company that solves a lot of problems for its customers and is well positioned for some of the mega themes of the next decade.

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Whitbread

Whitbread (WTB) has been in business since 1742 when it started out as a brewer. Over the last 25 years it has transformed itself from a leisure conglomerate – owning a brewery, an estate of pubs, David Lloyd health clubs, Marriott Hotels, Costa Coffee and Pizza Hut franchises – to focus solely on its Premier Inn budget hotel business.

A lack of clear strategy combined with exposure to a weak UK consumer economy has not made Whitbread a particularly good long-term investment. During the last decade, its shares have returned a very disappointing 28.3 per cent against 66.2 per cent for the FTSE All-Share index.

The last year has seen the shares perform strongly with gains of 31.3 per cent (FTSE All-Share +3.1 per cent) as the company has recovered well from Covid-19. Current trading remains strong which provides grounds for thinking that the shares can keep on outperforming.



Source: LSEG

A leading UK consumer brand

In Premier Inn, Whitbread owns one of the leading and most recognised consumer brands in the UK.

The key attraction of Premier Inn's business model is that it offers the customer a no-frills experience at a decent price. They are not paying for facilities they don't use and often stay in modern, well equipped rooms that are well maintained unlike those on offer at many independent hotels.

If customers want to eat breakfast or an evening meal, a pub restaurant is often conveniently located nearby.

Budget hotels have been growing steadily since Travelodge opened its first hotel in 1985. Since then, the likes of Premier Inn, Holiday Inn, Ibis and Best Western have invested in the sector.

Premier Inn has become the market leader and is well placed to keep on growing as it offers a combination of quality and value that appeals to both leisure and business customers. 37 per cent of Premier Inn's rooms were sold for less than £80 during the six months to August 2023.

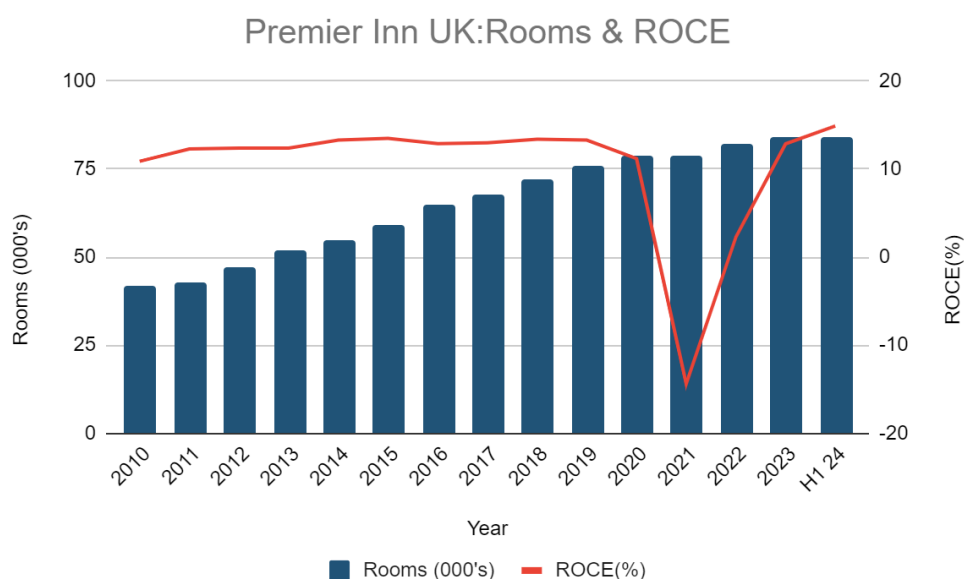
Premier Inn well placed for further profitable growth in the UK

One of the key investment attractions of any company is its ability to invest money at attractive rates of return in order to grow its future profits and cash flows.

This looks to be the case with Premier Inn where its UK hotels are now earning very respectable returns on capital employed (ROCE) of nearly 15 per cent. This is an impressive recovery from the hammering the business took during the Covid-19 pandemic.

New hotels will take a while to reach this level of profitability but investment in maturing hotel rooms gives Whitbread a nice platform to grow its profits.

Premier Inn had 83,934 rooms available at the end of August 2023 and has a target to reach 125,000 over the next few years.



Source: Whitbread

The industry backdrop is currently very helpful to Whitbread achieving this. The independent hotel sector continues its steady decline which has seen its share of the market fall from 52 per cent in 2015 to around 45 per cent currently. Over the same period, Premier Inn's market share has increased from 9 per cent to 12 per cent.

With recovering business and leisure demand in the UK, there is currently a shortage of new room supply coming on stream. New construction levels are at historic lows with lots of independent hotels converting to an alternative use.

With around 300,000 rooms in the independent sector, many will struggle to match the marketing and investment firepower of Premier Inn in the battle for customers.

This gives Premier Inn a favourable tailwind to keep on taking market share. London remains a key area for expansion as Premier Inn remains under-represented in this key market.

Premier Inn currently has 17 per cent of its rooms in London compared with around 29 per cent for the UK mid-scale and economy hotel market as a whole.

Wooing the business customer

Premier Inn already has around half of its revenues coming from business customers, but it continues to push for a bigger slice of this market. It is doing this by expanding the number of its business accounts, rewarding loyalty and partnering with travel management companies.

In addition to this, the company is increasing its supply of premium rooms with bigger beds, better Wi-Fi and more perks such as fridges and complimentary products.

In a fragile UK economy, Whitbread believes that business customers can be won from the more upmarket and expensive four star sector and that premiumisation can drive up its revenue per available room or REVPAR*.

*REVPAR is the average room rate multiplied by the occupancy rate.

Germany to start contributing to profits

Whitbread has sunk more than £1bn into the German hotel market with the aim of replicating its UK business model. It currently has 16,000 rooms, having added 10,000 rooms over the last four years. This puts it close to rivals such as B&B Hotels (18,000) and Ibis (22,000).

The German market is 40 per cent bigger than the UK and is very fragmented with no clear market leader. Like the UK market, its independent sector is in decline, but the branded budget sector's share of it is only around 12 per cent compared with 31 per cent in the UK.

The market is well supported by a significant short stay domestic travel demand and business customers from the large number of trade fairs in big cities.

Whitbread is using a combination of new builds and acquisitions to grow its presence and is also adopting a slightly different selling model to the UK. In addition to a direct selling model using the Premier Inn website and business accounts, it is trialling the use of leading hotel room sellers such as Booking.com (see our review of **Booking Holdings (Nasdaq: BKNG)**) in order to drive growth.

The German business has been losing money and is still expected to lose £30mn-£40mn this year. The good news is that as the business seems to be maturing nicely with increased occupancy and room rate increases driving up REVPAR. As a result, it is expected to get to a breakeven position during 2024.

This still leaves the business some way from paying its way. However, the company remains confident that it can deliver returns on capital of 10-14 per cent in the medium term. This would imply operating profits of £100mn-£140mn on the money already invested which should provide a nice kicker to Whitbread's earnings over the next few years.

Debt levels are quite high but supported by valuable freehold assets

Premier Inn's UK business is 57 per cent freehold owned compared to just 22 per cent in Germany. The large number of leasehold hotels means that the business as a whole has a lot of debt, with net debt to Ebitda (earnings before interest, tax, depreciation and amortisation) expected to be just over four times at the end of March 2024.

For a business where profits are sensitive to the fortunes of the economy this level of indebtedness might be a cause for concern. However, interest cover of around six times suggests that the company is in a decent financial position.

Whitbread's balance sheet has around £4bn of land and building assets on it. These assets are stated at cost and it is highly likely that the market value of some freehold hotels will be substantially higher and help to underpin Whitbread's current stock market value of £6.8bn.

Shares look decent value given the prospect of steady earnings growth

Despite a strong 2023, Whitbread shares at 3,648p are not expensively valued at 15.6 times its next year's forecast earnings per share (EPS).

This week's third-quarter results showed continued strong trading in both the UK and Germany with 2024 profit guidance unchanged.

That said, with 2025 and 2026 EPS growth only in the 6 per cent range, you could be forgiven for thinking that these forecasts could be a little bit low given the strong profit momentum in both the UK and Germany which is supported by efficiency gains and ongoing share buybacks.

Throw in the strong asset backing and Whitbread shares look well placed for the next few years.

Parker Hannifin



Source: LSEG

The key attraction of the US stock market to UK investors is that it is full of very good companies that can keep on growing in value. Many of these companies are household names, but there have been some less well known companies that have delivered outstanding returns for their investors.

Parker Hannifin (NYSE:PH) is one such company. It is the world's leading manufacturer of motion and control technologies and will be known to some UK investors for its recent takeover of Meggitt.

With a market capitalisation of \$58.8bn, the company's shares have returned 50 per cent over the last year and 289 per cent over the last decade, comfortably outperforming the S&P 500 index.

The company also has one of the most impressive dividend growth records on the US stock market, having increased its payout to shareholders for 67 years in a row.

A cursory glance at some of its financial ratios shows a business with very decent levels of profitability. Profit margins of over 20 per cent; free cash flow margins approaching 15 per cent; a great record of turning profits into free cash flow and returns on operating capital of 22 per cent.

These are the kind of numbers that are a result of a business doing a lot of things right and serving its customers well.

Parker Hannifin has a leading 13 per share of the \$135bn motion and control technologies market and wants to increase that to 20 per cent over time.

It has built up a strong competitive position underpinned by a large global distribution network which serves its small- and medium-sized customers.

Understanding Parker Hannifin

At first glance, Parker Hannifin is the kind of company that could make your eyes glaze over – there's so much going on with it.

When you look at manufacturing businesses of any kind it can be quite daunting. The products and markets involved can contain lots of technical jargon which might have you reaching for a dictionary to try and understand what everything means.

Whilst some kind of understanding of the products does no harm, it is not something that the investor should obsess about. What's arguably more important is to grasp the markets they are selling into and whether these have the potential to deliver future revenue and profits growth.

Parker Hannifin currently has just under 100 separate companies and over half a million business customers. Its products are sold into pretty much every manufacturing, transportation and processing industry.

Here's a very brief overview of its businesses and some of the thousands of products that they sell:

- Engineered materials – seals, adhesives, coatings and thermal products.
- Filtration – products that ensure the purity of critical process chemicals and also to remove contaminants from fuel, air, water and gases.
- Fluid connectors – fluid and flow controls used in fluid and gas handling.
- Mobile systems – hydraulic, pneumatic and electromechanical components used in mobile and industrial machinery.
- Aerospace – products used in commercial and military airframes and engines.

The company's Diversified Industrial division accounted for more than three quarters of its revenues last year and sells its products into major markets such as manufacturing, packaging, processing, transportation, mobile construction, refrigeration, air conditioning and agricultural machinery.

The Aerospace division sells to original equipment manufacturers but also has a substantial aftermarket revenue source from spare parts, maintenance, repairs and overhauls.

Plugged into growth markets with higher quality revenues

As well as being a play on industrial production activity, Parker Hannifin has positioned itself to benefit from growth markets.

Billions of US dollars are expected to be spent by companies and governments on upgrading and automating factories, clean energy and the reshoring of supply chains. This will lead to increased demand for construction, transportation, energy and factory automation equipment.

Parker Hannifin expects to see strong growth from electric vehicles which include up to twice as many of its products as internal combustion engine vehicles. It also expects to benefit from the growth in semiconductors, 5G mobile towers and data centres.

In aerospace, strong demand is expected from the continued recovery of the commercial market and the increased production of widebody aircraft as well as increased defence spending.

In addition to growing markets, Parker Hannifin should benefit from a more resilient and higher quality revenue mix.

It is shifting its sales toward products with long life cycles and the substantial after-market revenues that come with them. By 2027, the company expects 85 per cent of its revenue to come from long cycle products or aftermarkets.

This would be a welcome development for investors as it would make Parker Hannifin's profits less sensitive to the ups and downs of the general economy. More stable earnings are highly sought after by investors and the lower risks that come with them often result in higher stock market valuations over time.

Improving margins and free cash flow generation

The company is confident that its mix of businesses can sustain annual organic revenue growth of 4-6 per cent over the next few years with growing profit margins. This has resulted in a target EPS growth of at least 10 per cent per annum.

Free cash flow is also expected to grow strongly from \$2.2bn in 2022 to \$3.5bn by 2027. As well as sustaining further dividend growth, the company is expected to pay down debt rapidly and reduce its financial gearing.

A high quality business available at a reasonable price

Parker Hannifin has been a very good business for some time now, but it seems that even better days could be ahead of it.

The acquisition of Meggitt has given it exposure to a recovering aerospace market and has improved the quality of its revenues.

In a nutshell, Parker Hannifin seems to offer investors an attractive mix of growth, more secure revenues, better profitability and cash generation.

The price tag for all this seems very reasonable. At \$457 per share, this equates to a one year forecast PE ratio of 18.9 times backed by a free cash flow yield of 5 per cent. This looks like a good deal for long-term investors.

The company upgraded its profit guidance for the year to June 2024 back in November and will report its half-year results in early February.

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